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SUBJECT: CFETS UPDATE ON FX AND BOND MARKET DEVELOPMENTS

REF: A. A) 06 SHANGHAI 7096
[B. B\) 06 SHANGHAI 7091](#)
[C. C\) 06 SHANGHAI 2384](#)

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[1](#)1. (SBU) Summary: China Foreign Exchange Trading System (CFETS) President Xie Duo told Embassy ECON M/C Robert Luke on April 19 that CFETS continued to carry out policies to make China's foreign exchange (FX) trading system more market-based and efficient, including: increasing the number of over-the-counter (OTC) spot FX market makers from 15 to 22; updating the formula for calculating the opening price (central parity rate) of the RMB; launching a new Reuters-designed trading platform; and revising CFETS' fee schedule to adhere more closely to international norms. A bank in Tianjin was being allowed to hold net open positions shorting the USD on an experimental basis. The People's Bank of China (PBOC) was promoting the use of Shanghai Interbank Offering Rate(SHIBOR)-based products, launched in January, to develop a domestic benchmark and yield curve. The interbank bond market was now "very large for a developing market," but the corporate bond market was still underdeveloped. CFETS' application with the U.S. Commodity Futures Trading Commission (CFTC) to offer Chicago Mercantile Exchange (CME) products in China had run into regulatory hurdles, making its hoped-for June 2007 launch unlikely. End summary.

[1](#)2. (SBU) CFETS President Xie Duo and Vice General Manager Song Jianqi told visiting Embassy ECON M/C Robert Luke on April 19 that, over the past year, CFETS had carried out many "interesting changes" in order to meet PBOC's "simple objective" of "including more market-based elements" in China's foreign exchange system. Xie said PBOC was not involved in CFETS' daily operations or overtly setting the price of the RMB, but that it was still able to "indirectly intervene." The RMB appreciated to a new high against the dollar on April 20, closing at 7.7165. This represented a total appreciation of 7.26 percent since

July 21, 2005.

RMB FX Volume: Still Not Saying

13. (SBU) As in past visits (Ref A), Xie declined to answer a direct question about the total volume of FX trade through the CFETS system. The PBOC had not yet publicly announced trading data since it was worried that such information could prompt "misunderstandings and market speculation," he said. According to Xie, the volume of FX turnover was two times more in 2006 than it had been in 2005. Xie added that more than 90 percent of spot trades were OTC, and that market makers now accounted for more than 80 percent of the OTC trade volume. CFETS FX derivative markets had continued to develop, but swaps were now more popular than forwards since they allowed investors to manage both exchange rate and interest rate risk. The forwards market, introduced in August of 2005, had diminished in importance and now averaged only about USD 100 million per day. The swap market, introduced in April 2006, had taken off and now accounted for about USD 1 billion per day (Ref A).

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Market Makers Increase in Number and Importance

14. (SBU) There were now 22 market makers in the OTC spot market (up from the original 15), with seven more banks added in December 2006. Of these, four were Chinese banks -- China Minsheng Banking Corp., Hua Xia Bank Co., China Everbright Bank, and China Development Bank -- and three were foreign banks -- Deutsche Bank, Tokyo-Mitsubishi and Sumitomo Mitsui Banking Corp. (Note: These banks began acting as market makers on December 18. Of the 22 market makers, 13 were Chinese and nine

SHANGHAI 00000247 002 OF 004

were foreign. See Ref B for market makers' views on FX developments. In addition to the three listed above, the other foreign market makers are: HSBC, British Standard Chartered, Citibank, ABN-AMRO, Credit Agricole, the Bank of Montreal. In addition to above-listed four new members, the original Chinese market makers were: Industrial and Commercial Bank of China, Bank of China, Agricultural Bank of China, China Construction Bank, CITIC, Bank of Communications, Shanghai Pudong Development Bank, China Industrial Bank, and China Merchants Bank. End note.) Xie explained that the market maker banks engaged in trading of renminbi debt (interbank repo and bond) instruments differed from those involved in FX trading although there was some overlap. He noted that a few foreign banks were active in this trade as well. For example Citibank Nanjing branch was active in the renminbi debt market, although not in the FX market.

15. (SBU) The trading volume of foreign bank market makers, particularly HSBC, Citi, ABN AMRO and Bank of Montreal, had increased because they generally offered the best prices. Xie attributed this success to foreign banks having better trained staff, and more skilled and highly compensated traders than at Chinese banks.

16. (SBU) Xie said that CFETS methodology for calculating the daily central parity price had not undergone any changes, but that the weights assigned to each of the market makers (Ref C) in calculating the opening trading price had changed based on their respective trading volumes. He said that the Bank of China now only accounted for about 15 percent of OTC FX trades and that its weight had been adjusted downwards accordingly, but did not disclose any additional specifics on the "black box" in which the calculation was made.

"No Idea" How Central Bank Intervenes in FX Market

17. (SBU) Xie said PBOC did intervene indirectly in the FX market

in order to achieve its policy objectives, but he "had no idea" of the mechanism that the PBOC used to accomplish this intervention. There was, he said, "no direct link between PBOC and the Bank of China." Though PBOC was not a CFETS member, Xie acknowledged that it had relationships with what he deemed "premium dealers" and that it made its trades through these dealers. In addition, Xie said PBOC was still concerned with excess liquidity, inflation and overheating and "was clearly determined to control inflation through market measures rather than administrative measures" whenever possible.

New Trading Platform Launched

¶8. (SBU) CFETS launched its new trading platform (ref A) in March 2007 to adhere more closely to international norms and to create a platform for more FX derivative products. Xie said that its cooperation with Reuters in designing the software had been very successful and that the software was "running on American computers." Xie said that the new software system played to the strengths of the foreign bank market makers who "were very good at trading currency." The new platform allowed for spot, forward and swaps to trade on the same platform, with the screen listing only the best price offered.

¶9. (SBU) During a tour of CFETS' operations center, Luke observed CFETS employees monitoring spot and swap trading of the RMB as well as the Shanghai Interbank Borrowing Rate (SHIBOR) and bond trading. Three large screens dominated the room. One screen showed the RMB-USD trading price, one showed the SHIBOR rate, and the third showed the status of CFETS' computer network overlaid on a map of China. Song told Econoff that CFETS' staff had grown by 60 in 2006.

SHANGHAI 00000247 003 OF 004

Lower Fees

¶10. (SBU) Xie noted that CFETS had implemented a new fee structure on April 6. These fees were 30 times less than it had charged previously. For example, where fees had been USD 3 for every USD 10,000 exchanged, it now only cost USD 10 for every USD 1 million exchanged. Xie also said that the fees declined on a sliding scale based on the maturity or size of the trade. (Note: More information on the fees can be found in Chinese on CFETS' webpage: http://download.chinamoney.com.cn/content/onl ine2002/URLContent/gonggao/2007_80.doc End note.) According to Xie, CFETS also charged prices consistent with international practice for hard-currency to hard-currency trades. Volume for this type of trade was only about USD 15 billion per year and represented a fraction of CFETS workload. Only small banks lacking international relationships of their own needed this kind of service, he said.

Agreement "in Principle" for Additional Liberalization

¶11. (SBU) Xie said that PBOC and the State Administration of Foreign Exchange (SAFE) had agreed "in principle" to: 1) allow banks to hold net open positions shorting the dollar (or longing the RMB); and 2) widen the daily USD/RMB trading band from its current .3 percent limit. This would be in alignment with its stated goal of "adding more market principles." Initially, Xie said he expected this to occur in the next six months, then he qualified his remarks by saying, "I don't know when or whether." He added that, given the "oversupply of USD" in the market, widening the band now would "have no effect."

Experimenting with Two-Way Net Open Positions

¶12. (SBU) One bank, located in Tianjin, had been designated by CFETS to experiment with two-way net open positions; i.e. holding positions that either longed or shorted the dollar, to allow CFETS to "gain experience and understanding" on how to manage such a policy change. Luke speculated out loud that the bank selected was Bohai Bank. Xie refused to comment. (Note: Bohai Bank is not one of CFETS market makers, but is a CFETS FX trading bank. Aside from the bank in Tianjin, all other banks in China are still prohibited from holding net open positions that short the dollar (or long the RMB), a policy that traders says operates as a one-way constraint on China's development of its FX system (Ref B). End note.)

SHIBOR

¶13. (SBU) Xie said PBOC had encouraged the development of financial tools and products, such as SHIBOR and the domestic bond market to help develop China's banking and FX markets. SHIBOR's January 2007 launch had created a domestic benchmark and yield curve that would allow PBOC more ability to use interest rates in carrying out macroeconomic policies and would provide the necessary conditions to develop China's FX and derivatives markets. (Note: During the tour of the operations center, the screen displaying SHIBOR rates showed a yield curve for different maturities with short-term rates exceeding longer-term rates. End note) At an April 13 PBOC conference Xie had attended in Beijing, PBOC stated its intent to gradually deregulate China's lending and deposit interest rates as its confidence with SHIBOR developed. Xie said there were currently 16 commercial banks acting as SHIBOR market makers. (Note: Four

SHANGHAI 00000247 004 OF 004

of the SHIBOR market maker banks are Chinese: Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and CITIC Bank. The other 12 are foreign banks: Credit Agricole, HSBC, Citibank, Deutsche Bank, ABN AMRO Bank, ING Bank, Bank of Montreal, Royal Bank of Scotland, Standard Chartered Bank, ANZ Bank, UBS Bank, and Mitsubishi Bank of Tokyo. End note.)

¶14. (SBU) Xie said that, in March, the interbank bond/repo market turnover was RMB 9 trillion (USD 1.2 trillion), "very large for a developing market." The longest bond offered was a 30-year Treasury bill. The interbank bond market had no maturity restrictions and bonds were sold by public auction. Other bonds included policy bank bonds, commercial bank bonds and OTC bonds. The corporate bond market, however, was very small, with trading volume in March of only about RMB 100 million (USD 12 million.)

Problems with CME

¶15. (SBU) CFETS' goal of becoming a super clearing member of CME, eligible to sell CME products in China, continued to await CFTC approval. As Xie understood the problem, because of its structure, CFETS was unable to meet CFTC's capital requirements. While CFETS generated "lots of money" every year, this all went to PBOC. CFETS was an institutional organization (shiye danwei) of PBOC and had no independent capital. Xie expressed concern that CFTC did not understand the Chinese organizational structure and said, "If I make a mistake, I can be arrested or even killed -- but as an institution, CFETS could never go bankrupt." Xie said that CFETS had even tried to get permission from PBOC to be established as an independent company in order to meet the capital requirements, but the Ministry of Finance had refused. Xie said it was unlikely that CFETS would meet its previously announced deadline of June 2007 to begin offering CME products.

¶16. (SBU) Note: Consulate has subsequently conveyed Xie's remarks to CFTC. CFTC understands CFETS' organizational

structure and the Chinese concerns and is currently considering
its application.
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